United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

74-2582

United States Court of Appeals

FOR THE SECOND CIRCUIT

Bole

ROSALIND FOGEL and GERALD FOGEL,

Plaintiffs-Appellants,

versus

GEORGE A. CHESTNUTT, JR., JOHN CURRIER, FRANK G. FOWLER, JR., WARREN K. GREENE, RICHARD W. RADCLIFFE, STANLEY L. SABEL, FRANCIS L. VEEDER, AMERICAN INVESTORS CORPORATION, CHESTNUTT CORPORATION AND AMERICAN INVESTORS FUND, INC.,

Defendants-Appellees.

BRIEF FOR DEFENDANTS-APPELLEES

ROGERS HOGE & HILLS
Attorneys for Defendants-Appellees (other than American Investors Fund, Inc., nominal defendant)
90 Park Avenue
New York, New York 10016
(212) 953-9200

Of Counsel:

CLENDON H. LEE

2

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases:

United States Court of Appeals

For the Second Circuit

Rosalind Fogel and Gerald Fogel,

Plaintiffs-Appellants,

versus

George A. Chestnutt, Jr., John Currier, Frank G. Fowler, Jr., Warren K. Greene, Richard W. Radcliffe, Stanley L. Sabel, Francis L. Veeder, American Investors Corporation, Chestnutt Corporation and American Investors Fund, Inc.,

Defendants-Appellees.

BRIEF FOR DEFENDANTS-APPELLEES

Counter Statement of Issues Presented Pursuant to Rule 28(b) F.R.Ap.Pr.

1. Whether dismissal should be affirmed because plaintiffs failed to comply with Rule 23.1, F. R. Civ. Pr.

2. Whether, over the opposition of a board majority of statutorily "unaffiliated" directors,* this Court should be the first to declare that a corporation had a fiduciary duty to change the nature of its business and enter a new business for purposes of joining minor satellite cartels to accomplish self-dealing and conflicts of interest, or, alternatively, through spurious activity to engage in sham and deceit.

3. Whether a victim of cartels was required to attempt to join them.

---

* Defined, Section 2(a)(3), Investment Company Act of 1940.

4. Whether hypothetical *profits* of a non-existent brokerage entity can be considered in connection with "fact of damage", especially where it was shown that expenses of the non-existent entity would have far exceeded its gross receipts.*

5. Whether an investment Adviser in the guise of posturing "fiduciary duty" was required to utilize brokerage from investment company portfolio transactions on regional exchanges as a means of whittling down the Adviser's *own* overhead, while seeking a rainbow of saving investment company expense.

6. Whether without lying or changing the nature of their business defendants could have joined the National Association of Securities Dealers, for whatever purposes, nefarious or otherwise.

7. Whether a court of equity can possibly say that fiduciaries formerly had the duty to act in a manner Congress has now flatly prohibited after years of legislative pushing failed to move the Securities and Exchange Commission fast enough or far enough.

8. Whether plaintiffs have carried their burden of proof, on any theory of "violation", especially where any "fact of damage" is precluded.

---

* Plaintiffs do not contend that NY Stock Exchange Membership was available (Brief, p. 41). Accordingly, this case involves potential gross receipts of $23,405 and $56,875 over a 21-month period of so-called "give-ups" on the PBW and Pacific Exchanges, while *annual* expenses of any brokerage firm which might have been created would have been $150,000 to $200,000 in *each* such years, or 3 to 4 times greater than potential gross receipts. The big numbers in the record are irrelevant, and abandoned.

Counter Statement of Case Pursuant to Rule 28(b) F.R.A.P.

A "No-Load" Fund

Defendant George A. Chestnutt, Jr. ("Chestnutt") has been in the investment counselling business since 1946, both managing individual accounts and publishing an advisory service to subscribers called "American Investors Service" (Tr. 108-116). "Tr." means trial transcript.

In 1957 American Investors Fund, Inc. (the Fund), a New York corporation, was formed and issued its first prospectus in 1958. The Fund's first million dollars of shares were sold to subscribers to "American Investors Service" (Tr. 114) published by a partnership, American Investors Company, later becoming American Investors Corporation, then reincorporated in Connecticut as Chestnutt Corporation ("the Adviser") in 1966.

The Fund is a "no-load" fund under § 10(d) of The Investment Company Act of 1940 (the Act).* It initially

---

* 15 U.S.C. 80a-10(d), including the amendment effective December 15, 1971 substituting words "interested persons" for "affiliated persons" provides:

"10(d) Notwithstanding subsections (a) and (b)(2) of this section, a registered investment company may have a board of directors all the members of which, except one, are interested persons of the investment adviser of such company, or are officers or employees of such company, if—

(1) such investment company is an open-end company;

(2) such investment adviser is registered under title II of this Act and is engaged principally in the business of rendering investment supervisory services as defined in title II;

(3) no sales load is charged on securities issued by such investment company;

(4) any premium over net asset value charged by such company upon the issuance of any such security, plus any discount from net asset value charged on redemption thereof, shall not in the aggregate exceed 2 per centum;

(footnote continued on next page)

paid a flat 1% advisory fee to the Adviser, which was the rate in effect at the time plaintiffs made their first purchases in January 1963, and which rate was voluntarily reduced below the statutory level for no-load funds in 1964 (Stip., 27-28a), after the fund had reached about the $12 million level.

The Fund is sold by direct mail and advertising (Tr. 137-139). The Adviser used mailing lists and advertisements in financial papers and certain New York and Los Angeles newspapers (Tr. 139). The Adviser "keyed" its advertising in order to determine its effectiveness and knew from correspondence that the Fund's reputation spread by word of mouth, which the Adviser referred to as "radiation" in its contemporaneous sales records, abbreviated "rad." (Tr. 140).

About 40% of the Fund's sales were attributed directly to advertising, "known ads that we put in . . .", "keyed" for advertising response and about 45% to 50% to "radiation". Chestnutt attributed some of the "radiation" to advertising, although it is not measurable. In a falling market, advertisements were predictable failures (Tr. 141).

It took about 5 years for the Fund to attain total assets of $5 million (Ex. E), at which level newspapers first published daily quotations.

(continued from previous page)

(5) no sales or promotion expenses are incurred by such registered company; but expenses incurred in complying with laws regulating the issue or sale of securities shall not be deemed sales or promotion expenses;

(6) such investment adviser is the only investment adviser to such investment company, and such investment adviser does not receive a management fee exceeding 1 per centum per annum of the value of such company's net assets averaged over the year or taken as of a definite date or dates within the year;

(7) all executive salaries and executive expenses and office rent of such investment company are paid by such investment adviser; and

(8) such investment company has only one class of securities outstanding, each unit of which has equal voting rights with every other unit."

The Securities and Exchange Commission has taken note of the special niche of "no-load" funds in "Public Policy Implications of Investment Company Growth" (1966, Ex. 4, p. 53; Tr. 126) stating:

> "From the small investors point of view the sales load is by far the principal cost of a mutual fund investment. Most mutual fund investors are small investors, and the 8.5% sales load they normally pay is—assuming that the net asset value of the Fund's shares does not change—almost 19 times the prorated share of the customary annual advisory fee of ½ of 1%."

Plaintiff Rosalind Fogel attended college (Ex. R, p. 5). Her husband had four years of accounting education (Ex. R, p. 16), and they carefully reviewed the records of investment companies' performance and deliberately commenced buying Fund shares (Ex. R, pp. 9, 11) in 1963 because it was a no-load fund and she would not have to pay a 9.3% load or commission, as she had in her prior purchase of a different fund. She testified:

> "We were shopping for something that would save us a commission fee. It was a no-load fund and appealed to us because of the performance record." *

(Ex. R. p. 7, see also pp. 5-16).

Notwithstanding the Fund's "performance record", when plaintiffs commenced buying in January 1963 (Ans. ¶ 2, 15a) the Fund's total net assets were only $6.6 million (Ex. E). Plaintiffs made a number of cash investments including one of $200 on January 10, 1969, six months after commencing this suit and two years after commencing their first action (67 Civ. 60), referred to pp. 27-28, *infra*.

---

* Plaintiffs' brief (p. 58 fn.) slurs the Fund's investment record which for its entire history 1958 through 1974 appreciated exactly three times as much as the Dow-Jones Industrial Average, or by 116.5% versus 38.4% (including reinvestment of capital gains but excluding income distribution).

The SEC noted (Ex. 4, p. 52) that approximately 60 no-load funds were only a little over one-twentieth, or about 5%, of the mutual fund industry (Ex. 4, p. 52, 59), and described the distinctive industry pattern which obtained with the no-load funds under Section 10 (d) of the Act (at p. 59):

> "No-load shares are sold by the fund itself with the aid of its investment adviser. The absence of a sales load precludes the development of the complex distribution systems and the exertion of the vigorous direct selling efforts characteristic of the load funds. No-load funds employ no salesmen. However, they and their advisers stimulate share sales by advertisements in newspapers and periodicals, stating that the fund is a no-load fund and inviting requests for copies of its prospectus. And some no-load funds encourage brokers to recommend their shares to prospective investors by directing their portfolio brokerage business to those brokers who promote[*] the sale of their shares. Other significant sources of business are the advisers general nonfund advisory clientele, recommendations by lawyers, bankers and others on whom people rely for investment advice; articles in the financial press; the reputation of a particular fund for investment expertise; and new investment by existing shareholders.
>
> "These methods of obtaining business have been considerably less effective than the load funds' far more vigorous, personalized selling drives. Hence the no-load funds have only a small share of total mutual fund assets and shareholder accounts."

Since the Fund is a no-load fund, there was never any legal or economic function to be performed by an "underwriter" or "dealer" in what the SEC calls a "complex distribution system".

---

* N.B.: "promote", rather than "sell".

By contrast, an underwriter (or "dealer-distributor") is an integral, functioning link in the sale of load funds. The underwriter has both legal and economic functions in that the underwriter "buys" shares from a fund at wholesale and "sells" shares to other dealers, or else sells to the public directly through the underwriter's captive sales force, thereby avoiding having to split the "load" or commission with retail dealers or brokers.

These methods of doing business, amply described in the numerous prospectuses of "load" funds introduced by plaintiffs, need no elaboration. Many load funds are parts of huge conglomerates (for example, the $6 billion dollar "IDS" complex, Stip. 29a). Many have been formed by New York Stock Exchange brokerage houses, at least in part to stimulate commission business on the Exchange as well as to obtain up to 9.3% of the small investors' funds as a load or commission.

The SEC (Ex. 4, also at p. 53) further stated:

> "The $85 sales load on a $1,000 purchase of mutual fund shares from which an 8.5 percent load is deducted is 9.3 percent of the $915 that actually goes to the fund and would be described as a 9.3 percent charge, if mutual fund sales loads were computed in the way in which selling commissions and discounts are usually computed in the exchange and over-the-counter markets." (footnotes omitted)

Technical Analysis

The Adviser's advice is based on "technical analysis" (Tr. 110-115). About 95% of the selection and timing of the transactions is derived by in-house technical research (Tr. 116-123). Nothing is derived from brokerage firms (Tr. 121), but brokers are on the phone with suggestions, and every day's mail contains studies which the brokers submit to stimulate business.

The technical analysis is minutely described in all the prospectuses (Ex. 5-15) of the Fund. It is sufficient here merely to note that the Adviser keeps daily statistical records on approximately 1300 stocks, divided into 70 industry groups, and that the data are fed into the predetermined program of a computer, which ranks such stocks in percentile groupings which shows their *"relative"* market strength, both by individual stocks and by industry groups. The Adviser publishes weekly information with respect to 1,000 stocks of these 1,300, and with respect to the 70 industry groups therein.

An example of the weekly report is Ex. D. Chestnutt's pamphlet "Stock Market Analysis Facts and Principles" is Ex. N. Chestnutt described technical analysis, Tr. 110-123.

Small Shareholdings, Effect of "Load", Redemptions, Sales

As the SEC pointed out (supra, p. 5) "most mutual fund investors are small investors . . .". That is true of this Fund,* where the average shareholding of the Fund is about $2,000 (Tr. 126).

Reference to financial statements in the funds prospectuses (Ex. 5-15), shows for each year under "Statement Of Changes in Net Assets" both the proceeds from sales of Fund shares and the pay-out on redemption of Fund shares. At the end of 1962, and immediately prior to the plaintiffs' first purchase, the total net assets of the Fund were only $6.6 million. Nevertheless, for the 10 years 1962 through 1972 the Fund paid redemptions aggregating $363 million, or 55 times the Fund's total net assets at the beginning of the period.**

---

* In 1970 the Fund for the first time established a $400 minimum initial subscription, with subsequent investments of $10. (Ex. 12)

** Redemptions of $27.7 million and $14.4 million in 1973 and 1974 resulted in net redemptions, after sales of new shares, of $17.3 million and $4.4 million for such periods, respectively. Perhaps the blood bath is almost over. If small investors had "dollar

(continued on next page)

Thus, plaintiffs would have had no opportunity to invest, or continue investments, in a no-load fund, which would have been 55 times its 1962 height under water after 10 years, were it not for total sales of additional shares of $650 million in that 1963 through 1972 period.

Sales to accounts averaging $2,000 in size, at the customary "load" of 9.3% of invested capital, would have amounted to approximately $60 million paid to underwriters and distributors (and divided by them among salesmen and other dealers). However, since this Fund is a no-load fund, its shareholders saved that $60 million which was put to work as their investment.

Required Brokerage at Fixed Commission Rates

The SEC stated (Ex. 4, p. 53):

> "Injections of new capital into and withdrawal of old capital from a mutual fund lead to purchases and sales of portfolio securities that entail brokerage costs".

Amen. This was followed on page 54 with:

> "Since the cost of purchasing a round lot of a listed security, which is usually around 1 percent of the purchase price, must be paid by sellers as well as by buyers, the total cost of the purchase and subsequent sale of a listed security, assuming no change in the security's market price, is normally about 2 percent (1 percent when buying and a second 1 percent when selling) of the security's price."

(continued from preceding page)

averaged" by continuing buying, instead of being frightened, at least in part by groundless, indiscriminate and intemperate charges and litigation, they would be far better off. For example, this Fund's shares have increased about 70% in value since its low on September 13, 1974. Shares bought at last year's values would cover a multitude of prior psychological and economic panics.

Thus, a billion dollars in-and-out, turned over only once in a decade, would result at old (fixed) rates in brokerage commissions of $20 million on portfolio transactions of that billion dollars.

The SEC sought information which would be most relevant to 95% of the investment company industry*—namely, the load funds, many of which are affiliated with brokerage firms, or variously and increasingly conglomerated—and required information with respect to brokerage on portfolio transactions to be recorded 10 days after each quarter and disclosed in prospectuses. Reg. § 270.31a-1 (last amended February 1, 1963, 28 F.R. 179), Ex. J, CCH Fed. Sec. L. Reptr., ¶ 49,603. Ex. J, provides in relevant part:

> "(9) A record for each fiscal quarter, which shall be completed within ten days after the end of such quarter, showing specifically the basis or bases upon which the allocation of orders for the purchase and sale of portfolio securities to named brokers or dealers and the division of brokerage commissions or other compensation on such purchase and sale orders among named persons were made during such quarter. The record shall indicate the consideration given to (i) sales of shares of the investment company by brokers or dealers, (ii) the supplying of services or benefits by brokers or dealers to the investment company, its investment adviser or principal underwriter or any persons affiliated therewith, and (iii) *any other considerations other than the technical qualifications of the brokers and dealers as such*. The record shall show the nature of the services or benefits made available, and shall describe in detail the application of any general or specific formula or other determinant used in

---

* We understand that assets managed by bank trust departments (personal trusts, pension trusts, etc.) are about 10 times as large as the entire mutual fund industry, the aggregate of two New York banks' managed assets being equal to all mutual funds put together.

arriving at such allocation of purchase and sale orders and such division of brokerage commissions or other compensation. The record shall also include the identities of the persons responsible for the determination of such allocation and such division of brokerage commissions or other compensation." (Emphasis added)

Thus, the Commission forbade even the recording, as well as disclosure, as to "the technical qualifications of the brokers and dealers as such"—the only matter important to a dogmatic technician.

Instead, the Commission required recording and disclosure as to

(i) sales of shares of the investment company by brokers or dealers;

(ii) supplying of services or benefits to the investment company, adviser or *underwriter* and affiliates; and

(iii) any other considerations, *exclusive* of the above-mentioned *technical qualifications.*

This Regulation resulted in attributing *all* brokerage to one or another category. But, in both a realistic* and a formal legal sense, no broker *"sells"* Fund shares. The

* It is neither coy nor captious for defendants to refer to "assistance" in the sale of Fund shares, rather than "sale" (entire record). Sales are in *inter*state commerce by mail order to the bank Transfer Agent, or sometimes by telephone to the Fund. Brokers who put their $2,000 average size accounts into the Fund —where they ought to be—save themselves expense, time and effort, handholding, etc. while avidly seeking entree to institutional brokerage. For plaintiffs to contend throughout their brief that brokerage was related to "research" is blatantly false. There is not one iota of evidence to that effect. Chestnutt's underlying "technical" dogma is that market action reflects fundamentals before ponderous research reports get researched, written, reviewed and broadcast. Moreover, other great minds have already commenced to think in the same channels, and their purchases or sales have *already* shown up in market action, reflected in "technical analysis." Note also the SEC's use of the word "promote", p. 6, *supra*.

Fund and the Adviser have no use whatever for services from brokers, other than the best mechanical executions of transactions, and of course to be alerted promptly to market, financial and economic information. The prospectuses disclose this and it is repeated in the Answer (¶ 8-11; 16-18a). The court below found full disclosure as to these facts (335-336a).

Defendant Chestnutt testified (Tr. 170-175) as to the basis of the allocations to assistance in the sale of Fund shares, market information, and economic information. None of this is relevant to "recapture" on two regional exchanges. Since commission rates were fixed, the allocation of necessarily big numbers, after the fact, to various slots is irrelevant, and indeed misleading. The obvious administrative purpose was reasonably calculated to disclose self-dealings with *affiliated* brokers, which the Fund and the Adviser never had, but which plaintiffs claim should have been created for self-dealing or sham purposes, i.e., deliberate fraud.

As to slotting into Procrustean categories, Mr. Chestnutt testified (Tr. 171):

> "Q. Do I understand you, Mr. Chestnutt, to mean that every piece of brokerage has to be allocated to some particular category?
>
> "A. Yes. It is like saying if I send my wife to the A & P to get groceries and later on she had to allocate that purchase for some other reason than we were hungry."

And on the following page:

> "The Court: Mr. Chestnutt, with regard to this regulation, do you have to allocate 100 per cent of the Commission?"
>
> "Answer: Yes".

Accordingly, the numerous data included in the record with respect to brokerage allocations arise solely from the

reporting requirements of the SEC all directed at the "complex distribution system" of "load funds," as distinguished from "no-load funds" (see pp. 5-7, *supra*).

The Brokerage Involved in This Case

Plaintiffs contend defendants should have created a brokerage entity to have "recaptured" $23,405 on the PBW Exchange and $56,875 on the Pacific Coast Stock Exchange in the 21-month period ending December 5, 1968 when all stock exchanges changed their rules to stop "give-ups" (Tr. 347, Ex. 45).

Plaintiffs concede defendants were ineligible to join the New York Exchanges or contrive "recapture" thereon. Likewise, there is no proof and the record is silent as to other regional exchanges and the over-the-counter allegations (Pltfs. br., p. 41).

Accordingly, the entire complaint has been abandoned except new paragraph 21(a) in the Supplemental Complaint filed on the eve of trial.

Thus, all the big numbers in the record relating to total brokerage, and so-called "reciprocity" are irrelevant. There is not an iota of proof that the Fund did not obtain the best execution of its required portfolio transactions—and no money could be saved under the identical fixed commissions of all the exchanges.

Concerning the "Unaffiliated" and "Disinterested" Directors

At the time this action was commenced, 4 of the 7 Fund Directors were "unaffiliated." (Ex. 11).

While under Section 10(d) of the Act, the Fund could have had only one director who was not an "affiliated per-

son" (and later after December 15, 1971 an "interested person")—since this no-load fund did not charge an advisory fee in excess of one per cent—the Court below found that at all times there had been either three or four independent directors (328a). Director Currier who joined the Board in 1962 was an "unaffiliated director", both before and after joining the Board, but later acquired privately from an individual about 2% of the Adviser's stock. Under the 1970 amendments (effective December 15, 1971), creating a new definition of "interested person", Currier became an "interested person" thereafter, although remaining an "unaffiliated" director.

A. Director Richard Radcliffe

Radcliffe joined the Board in 1958 when the Fund was about $1 million in size.

His entire deposition, although taken by plaintiffs, was introduced in evidence by defendants as Exhibit Q. He also testified in person (Tr. 367-388). Plaintiff's counsel called him the "most sophisticated" of the unaffiliated directors (Ex. Q, pp. 1-11) for the good reason that following Radcliffe's graduation from Yale, he was from 1948 to 1950 at the American Institute of Economic Research in Great Barrington, Massachusetts; from 1950 through 1953 with White, Weld & Co. in the investment advisory department; from 1953 to 1965 was a managing partner of A. W. Jones & Co., the well publicized and highly successful partnership hedge fund; and from 1965 to the present a managing partner of Fairfield Partners, another hedge fund. Years of most esoteric and broad experience—25 of them—never led Radcliffe to recommend that either A. W. Jones & Co. or Fairfield Partners or American Investors Fund, Inc. have any affiliation with a broker. He was familiar with the efforts commencing in 1965 of certain load funds, having a functioning "underwriter-distributor", to participate through NASD membership in recapture, the hypothetical

profits of which might be used to reduce advisory fees (Ex. Q, pp. 23-28).*

Radcliffe did not believe that this experiment in self-dealing was applicable to the Fund

> "Because they are a no-load fund. They have no NASD member, broker-dealer, selling the Fund's shares and for that reason would not qualify for membership on any exchange that I know of" (Ex. Q, pp. 30-31).

At pp. 33-34 of Ex. Q, plaintiffs' counsel made it entirely clear that he was talking about a "paper company"; a "shell" that was not in the brokerage business; a "dummy" that would not be in the brokerage business and would be operating "solely for the purpose of receiving give-ups", doing no business for the public and would not have sold investment company shares to the public.

At pp. 44-46 of Ex. Q Radcliffe made his views clear that he would have been "opposed" to any such course, that

> "would have led the management company into a field on which they had no expertise and it would have been a diversion of their efforts and would have required that they set up some kind of a brokerage business" (p. 44).

And again, and going to the heart of the matter,

> "I think it would have caused them to make some different type of decisions than they were making, in

* It is stipulated in the pretrial order (29-30a) that Waddell & Reed, Inc., a $2.6 billion conglomerate, in 1965 apparently agreed to reduce the advisory fees by 50% of a brokerage subsidiary's *profits*, hopefully to be derived from running brokerage through different markets of regional exchanges for the purpose of "recapture". This self-dealing program resulted in a death sentence and consent order of extermination of Kansas City Securities Corp., which Waddell & Reed had formed. (SEC Releases Nos. 40-8556, 34-11072 and 428 under The Investment Advisers Act of 1940, all dated October 24, 1974).

the manner that first of all, there would be a question of the very conflict of whether you allocate commissions to yourself or whether you allocate commissions to brokers for executing orders and providing you with information and assisting in the sale of funds" (p. 46).

Radcliffe and all directors were, of course, completely familiar with the prospectuses and proxy statements, receiving proofs prior to directors' meetings and discussing the references therein to the Fund's brokerage practices (pp. 47-49). Radcliffe repeated his opinion that Chestnutt Corporation should stick to managing the Fund and not get into the brokerage business; that American Investors differed from other types of funds; that there was a "conflict of interests" leading to poor execution if there were an inducement to trade on the thin Pacific Coast Exchange and his own view that

> "I think there is a real risk that a Fund recaptures commissions is going to generate commissions, simply for the purpose of recapturing them, which means the investment decision is tainted by the desire to earn some money out of commissions" (pp. 57-58).

Radcliffe made it absolutely crystal clear and in the light of his experience:

> "I have always been opposed to the combination of brokerage and investment managers, and I think the two areas should be separated, that brokers should not be in the investment management business and investment managers shouldn't be in the brokerage business" (p. 59).

While Radcliffe had investigated becoming a broker, he had never sought it (p. 59).

Radcliffe's trial testimony (Tr. 367-387) is equally to the point. His background, personal placing of brokerage orders, both on the long and the short side for hedge funds

and his failure to recommend brokerage activity for A. W. Jones & Co., Fairfield Partners or the Fund are repeated (Tr. 367-372). With respect to the prospectus language of two other no-load funds, T. Rowe Price Growth Stock Fund and T. Rowe Price New Era Fund (Exhibits T and T-1), he was asked specifically whether the language in such prospectuses with respect to conflict of interest and diversion of energies of that adviser accorded with his views both presently and when he was a member of the Fund's Board. He was in emphatic agreement that those exhibits, disclosing management of well over a billion dollars and several times the size of American Investors Fund, Inc., that it would be improvident to participate in the brokerage business (Tr. 375-376).

Radcliffe noted the difference between load funds having an underwriter and no-load funds and in his judgment as a director, it was necessary for the Fund and its Adviser to promote the sale of Fund shares (Tr. 380-381). And he did know what Waddell & Reed was up to, and said ". . . it's not what I think American Investors should have been doing" (Tr. 378).

One such "unaffiliated" and "disinterested" director, all that is required of a no-load fund under § 10(d)(1) of the Act, "sophisticated", specialized, and experienced in the very field of portfolio transactions and who had served for 11 years while the Fund grew from $1 million to over $300 million, is quite sufficient to defeat plaintiffs' claim. The insiders could not have fooled him if they tried.

B. Director Eugene Ulrich

But the newest "disinterested" director, as well as the other directors, was to say the least well informed, and indeed was as peculiarly well qualified as Radcliffe.

Ulrich, with a Masters Degree from the Tuck School, in 13 years with Arthur Anderson & Co. audited other investment companies and investment advisers and com-

mon trust funds of Bankers Trust and Morgan Guaranty. He had been internal auditor of Sinclair Oil, Controller of B. P. Oil Corporation and was Assistant Controller of American Airlines (Tr. 331-334).

Coming on the Board in 1971, Ulrich never recommended that the adviser engage in brokerage; considered it a "conflict of interest" for the adviser even to be "connected with" brokerage or "doing brokerage business" (Tr. 336). Moreover, on cross-examination and apart from policy judgments, this director of varied experience in the investment company field concluded " . . . I think the cost of maintaining a brokerage business would probably exceed the benefits" (Tr. 337).

C. Director William F. May

Unaffiliated director May, who left the Board in 1965 after a couple of years because of a conflict (Tr. 358) upon joining the Bankers Trust Board, is a chemical engineer, holder of an Advanced Management degree from Harvard Business School, Chairman and Chief Executive of American Can Company, director of Johns-Mansville and the New York Times, and Trustee of Lincoln Center, University of Rochester, Dartmouth and Brooklyn Polytechnic Institute. He never recommended the formation of a brokerage firm (Tr. 361), just as he never sought to have his own corporation perform all types of services. Mr. May's service coincided with the growth of the Fund from $6.6 million at the end of 1962 to about $50 million, and with the reduction in the advisory fee from the flat 1% to the decreasing sliding scale described in the stipulation (27-28a) and prospectuses, Exs. 6, 7, and 8.

D. Director Frank Fowler

Plaintiffs took the deposition (Ex. P) of "disinterested" director Fowler, but did not offer it in evidence, and insisted that this "defendant" be produced, while neglect-

ing to advise the Court the "defendant" was never served (Tr. 345). When Fowler was produced at the next session of the trial some days later, plaintiffs declined to examine in open Court, presumably as a device to sidetrack oral examination of Radcliffe. Fowler, an independent businessman and engineer and director since 1962 was opposed to any involvement in brokerage (Ex. P, especially pp. 35-37).

E. Director Frank Veeder

Named but unserved defendant director Veeder died several months before trial and was never deposed.

F. Director John Currier

Currier, likewise having a Masters Degree from Harvard Business School, and president of a major division of Genesco, became a director in 1962 and thereafter acquired a less than 2% stock interest in the adviser. He continues to be an "unaffiliated" director, and during the period until December 1968, when "give-ups" were abolished, qualified to be the sole "unaffiliated" director, under Section 10(d) of the Act, becoming an "interested person" only after the 1970 amendments effective 1971 (Tr. 317-319).

He was opposed even to the "possibility" of having the adviser participate in brokerage (Tr. 322), and recognized the inherent conflicts and diversion of effort.

The Position of the "Affiliated Directors" and "Interested Persons"

A. Director George A. Chestnutt, Jr.

Chestnutt had always been an investment counsellor and an investment adviser. He had never been a broker or dealer. His opposition to being in the brokerage business is expressed throughout his testimony but can be noted

especially at Tr. 229 to 230 on cross examination, as follows:

> "Q. Did counsel advise you that it was illegal? A. They have advised me against it because it was fraught with self-dealing, with temptations of various sorts, and as I have said before, the expression Mr. Sabel used, shoemaker stick to your last.
>
> "It is an old expression and Mr. Sabel has used it repeatedly in telling me to stay out of the brokerage business and stick to the thing I know best, which is analyzing the market."
>
> "Q. If you form an affiliate that merely receives commissions and pays them back to the fund, where is the self-dealing? A. I didn't know that it was possible to do that and it never occurred to me until you brought it up."
>
> "Q. Did you ever make any inquiry of the NASD or of the Philadelphia Exchange which it was possible? A. NASD stands for National Association of Securities Dealers. That means that the members are securities dealers; not just holding out a place for a mail drop for checks to fall into. It didn't occur to me that it was a national association of check drop artists."

B. Director Warren K. Greene

Greene, who had spent some five years with First Boston Corporation and had received a Masters Degree in finance (Tr. 238) and had had intensive training and experience in the various departments of that firm (Tr. 239-241), was opposed to any entry into the brokerage or underwriting business by the adviser (Tr. 295-299). On the basis of his experience, and the fact that the Fund was a "no-load fund", he was asked on cross examination whether the adviser was eligible to be a member of the NASD, and he repeated what he had said on deposition, namely that since there was no dealer organization or underwriting affiliation

there was no need to be either a broker or a broker-dealer (Tr. 300). Then the Court stated:

"I am not questioning the wisdom or the prudence, I am just questioning your eligibility, and you testified, just read, that you weren't eligible, and I take it from what you just this moment told me you weren't eligible because you didn't meet the definition of broker or broker-dealer; is that it?"

The Witness: "That's right, sir."

The foolhardiness and the conflict of interest in creating any functioning brokerage affiliate for dealing on regional exchanges (as distinguished from a shell or a sham) was made crystal clear by the uncontradicted testimony (Tr. 311-313) that a proper allocation of expenses, including space, salaries of officers, salaries of traders and other overhead matters should be about $150,000 to $200,000 per year. Thus, if the Adviser had formed a brokerage affiliate to funnel and increase brokerage on the thin markets of regional exchanges, the amount of business done on such regional exchanges would have had to be vastly increased before there could have been any "net profits" to share with the Fund upon some formula, and in the meantime the Adviser could have unburdened itself of substantial annual expenses, to be paid for by Fund brokerage business placed on regional exchanges, for the sole purpose of ultimately creating a hypothetical profit of which the Fund would get some share. Indeed, if a brokerage affiliate for purposes of regional membership were formed, and it exactly broke even, the Fund would get nothing whereas the Adviser would have saved between $150,000 to $200,000 in overhead.

C. Director Stanley Law Sabel

Sabel had suffered strokes and was deposed by plaintiffs (Ex. 23, p. 4, Ex. O) both in this action and the prior action (67 Civ. 70). Practising since 1932 in New York, member

of Massachusetts and Connecticut bars,* a specialist in securities law, author of law review notes, holder of both LLB and LLM in corporation finance from Harvard, Sabel has continued as director of the Fund since inception.

His opposition to brokerage involvement was deliberate and principled, as well as soundly grounded on the judgment "Shoemaker stick to your last" (Ex. 23, p. 38). He clearly recognized that suggestions in the 1966 SEC report (Ex. 4) as to recapture were not applicable to a no-load fund. Copies were furnished all directors (Ex. 23, pp. 20-24). He pointed precisely to the language in Ex. 4 relating to "... dealer distributed funds" which shows the distinction in the SEC's own mind with respect to "recapture" availability (Ex. 23, pp. 54-55).

Sabel recognized the inherent conflicts in self-dealing brokerage for the Fund (Ex. 23, pp. 32, 36-38, 50, 81-83), and the opposition of disinterested directors, particularly Radcliffe and Fowler to any such conflict or sham and deceit.

Sabel was entirely familiar with the NASD rules for eligibility, and indeed it was those rules which had occasioned correspondence with the NASD (Ex. A) in March 1967.

He would not advise a "deceitful" (Ex. 23, p. 43) "letter drop".

At pp. 41-49 (Ex. 23) Sabel carefully analyzed the NASD eligibility requirements, especially at p. 46, where he quoted "... whose regular course of business consists in actually transacting any portion of the brokerage or investment banking business." (Also Ex. 23, p. 88)**

---

* Mr. Sabel has since passed and been admitted to the Georgia bar, where he resides at Saint Simons Island.

** We regret failing to assist the trial judge on brief, believing that Sabels' testimony with respect to NASD completely disposed of the matter. Nor are we chagrined that the trial judge cut plaintiffs off at the knees, while we emphasized a place below the ankles.

With respect to the Pacific Coast Stock Exchange, where plaintiffs contend there could have been some gross dollars "recaptured" before expenses, Sabel noted with precision the prerequisite of NASD membership to participate in that regional exchange, under whatever umbrella (Ex. 23, pp. 52-54). All of this had been his, as general counsel's, advice to the directors (Ex. 23, pp. 66-67). All prospectuses and proxy statements fully disclosing the Fund's brokerage practices—as the Court below found (336a)—had been provided to directors before their meetings (Ex. 23, pp. 78-79).

Defendants Manner of Doing Business

There is lengthy testimony with respect to the manner of placing orders and particularly the activities of Messrs. Chestnutt and Greene.* Plaintiffs seek to analogize advice and management to brokerage.

An advisory client gives a limited power of attorney to Chestnutt Management Corporation (the Adviser's subsidiary).

By such limited power of attorney that corporation as attorney-in-fact and agent for the investment counselling client gives buy and sell orders to the client's own broker who, of course, has been furnished a duplicate of the power to evidence the investment counsel's authority (Tr. 308-311).

All securities of investment counsel clients are held by the clients' own brokers (or sometimes by banks), and the power-of-attorney is limited to giving buy and sell orders. At the direction of investment counsel, it is the broker who carries out the order, or who "effects the transaction for

---

* They have been assisted by a maximum exceeding 100 employees (Tr. 167), required to manage many millions of dollars in hundreds of individual accounts, to carry out the technical

(continued on following page)

others" (Tr. 309), in the words of NASD eligibility rule. That is, it is the *broker* who buys, or sells, and makes or receives delivery on behalf of his customer, upon instructions of investment counsel as attorney in fact, and agent for the investment counselling client.

Witness Greene and others placed orders. To place an order with a broker is not to "effect" a transaction. The broker does that. Plaintiff's Brief (p. 29) attempts to change a colloquial ambiguity into a different function—the function of executing or effecting a transaction on the floor. For such an equivocation to be the linchpin of plaintiffs' argument as to NASD eligibility merely discloses the utter poverty of such contention.

Membership on the PBW or Pacific Coast Exchange

The decision below precisely analyzes the ineligibility of defendant to have become an NASD member, and did so in the identical terms of the deposition of the Fund's general counsel and director from inception (Ex. 23), pp. 21-23 *supra*.

Plaintiffs' only witness, as President of the PBW Exchange, left the witness stand to learn from his counsel (Tr. 57-58).

What he sought to find out in September 1973 is what plaintiffs claim defendants should already have known prior to January 1, 1963—a decade earlier—to induce them to change the very nature of their business and to change their methods of operation.

Witness Wetherill, President of the PBW and called by the plaintiffs, admitted (71a, Tr. 57, 72a, Tr. 58) that "to

---

(continued from preceding page)

analysis (Exs. D, F, N and 5-15) and publish the market letter. Officers and most higher paid employees for purposes of "Blue Sky" laws and technical proficiency have been required to pass numerous examinations, including the NASD.

get the customer directed give-up they would have had to be a member of the NASD". Apart from the give-up the only method of sharing in commissions was self-dealing, which the witness preferred to call "dealing with one's parent" and "for the sole purpose in most cases of these fifty institutional members that we have of handling one account" (70a, Tr. 56).

The same of course was true of the Pacific Coast Exchange where the eligibility requirement was that the "chief business is that of transacting business as a broker or dealer in securities" (Ex. 22, p. 8).

Defendants introduced what is frequently known as the "Loomis Letter" written by the then General Counsel of the SEC, now a Commissioner, which provided as follows (Ex. I):

> "You first ask whether mutual fund management has a fiduciary duty to acquire a stock-exchange seat, directly or through an affiliate, in order to utilize this means to recapture brokerage which in turn will be offset against management charges. We do not believe that management has this duty if in the exercise of its best business judgment [*] management determines that it is not in the best interest of the fund to create such an affiliate. Proposed Rule 10b-10, as published for comment on January 26, 1968, to which you refer, has been *withdrawn*." (Issued November 10, 1969, emphasis added)

"Withdrawn," forsooth—extirpated and now prohibited.

Consequences of Regional Exchange Membership

Since only a portion of *net* profits of a hypothetical and non-existent brokerage affiliate could under any theory be

* One searches plaintiffs' brief in vain for the slightest recognition of the "business judgment" rule. How, indeed, can a legal system embracing bodies corporate exist without such rule?

used for the benefit of the Fund, it is clear that any liability whatever is precluded.

The zenith of plaintiffs' case shows the actual experience where expense of experimental regional brokerage could be spread over 9 and 10 institutional investors, respectively.

The 1973 prospectus of Loomis-Sayles Mutual Fund which is affiliated with New England Mutual Life Insurance Company is Ex. 40. That insurance company controls and substantially owns the adviser, which also advises seven (7) additional investment companies (Ex. 40, p. 9). This multibillion dollar financial conglomerate joined two regional exchanges in 1971 and claims through self-dealing to have achieved *"net"* savings after expenses of $2,945 in 1972 on brokerage (Ex. 40, p. 10). Plaintiffs' other example, Scudder, Stevens & Clark Common Stock Fund (Ex. 41), which has 12 regional sales offices (back cover) and whose adviser was formed in 1919 and advises nine (9) additional funds (Ex. 41, p. 9), also took the fashionable plunge of self-dealing on regional exchanges in 1971 and claims to have effected $6,990 *"net"* savings in 1972 (Ex. 41, p. 12-13). That prospectus then states an obvious "business judgment":

> "There is no assurance that any such arrangements on the Boston, Detroit, Pacific or other stock exchanges will continue or will result in significant savings to the Fund. On January 16, 1973, the Securities and Exchange Commission stated that it is reviewing the ability of institutional members, such as the Fund, to continue to obtain a credit for a portion of its brokerage commissions on all or some of these exchanges."

Thus, while two conglomerated no-load funds have marched up the hill of self-dealing to posture their "fiduciary" duty to save a pittance, the SEC and Congress will force them back. (Ex. L, Ex. B, Ex. C, and now the "crusher" in the Securities Acts Amendments of 1975.)

Pleadings and Proceedings

A majority of the Fund's directors were "unaffiliated" at the time this action was commenced in July 1968.

That is, 4 out of 7, namely Radcliffe, Veeder, Fowler and Currier were "unaffiliated", both then and when "give-ups" were abolished December 5, 1968.

The complaint (¶ 24, 12a) alleges:

> "24. Any demand on the Fund's board to bring this action would be futile and is unnecessary because:
>
> "(a) The defendant directors are the principal wrongdoers herein, some of whom have personally profited from the wrongs alleged in this complaint;
>
> "(b) A majority of the Fund's directors took part in the wrongs alleged herein; and
>
> "(c) The directors are and would be hostile to the successful prosecution of the instant lawsuit."

There is no allegation ". . . with particularity . . . [of] the reasons for not making the [demand]" * that the directors bring suit as required by Rule 23.1, F.R. Civ. Pr.

The "unaffiliated" board majority had the power not merely to bring suit, but also to terminate the advisory agreement on 60 days notice. Indeed, § 15 of the Act required the *affirmative* approval at least annually by the *separate* majority of "unaffiliated" (since December 15, 1971 "disinterested" directors), and were there to have been only the single "unaffiliated" director required under

---

* Rule 23.1 provides in relevant part:

"The complaint shall also allege with particularity the efforts, if any, made by the plaintiff to obtain, the action he desires from the directors or comparable authority and, if necessary, from the shareholders or members, and the reasons for his failure to obtain the action or for not making the effort."

§ 10(d), he alone, would have held veto power over the advisory agreement.

This purely conclusory complaint (68 Civ. 2855), wholly lacking the required "particularity" under Rule 23.1, was filed in July 1968, eighteen months after the identical plaintiffs brought their first action (67 Civ. 60, "Fogel No. 1") complaining of brokerage practices and the advisory fee, but did not serve unaffiliated directors in Fogel No. 1 until February 1970, 3 years after commencement of Fogel No. 1, and 7 months after commencement of this action. The procedure in both cases is exhaustingly described in the mandamus petition* in "Chestnutt v. U. S. District Court (Hon. Lawrence W. Pierce, Judge, Docket 73-2150) in this Court which will be referred to in oral argument.

* The seven pages of docket entries in Fogel No. 1 are included in the petition, disclosing no less than eight series of Interrogatories and the flouting by a plaintiff of seven orders of 3 district judges, and at the same time imposing the burden in this case on defendants' employees of more than 2,342 hours of officers' and employees' time in answering additional interrogatories. These conclusory complaints represent the personal views of counsel, contrary to the statutory scheme. At hearings August 4, 1967 before the Committee on Banking and Currency, United States Senate (Ninetieth Congress, First Session) on S. 1659, at p. 708, Abraham L. Pomerantz, Esq. stated:

> "As indicated, I would prescribe stronger medicine. To sanction an external adviser is to create a corporate monster. Why can't the Mutual Fund do what every other American corporation does: internalize its management, i.e., hire and pay for its executive talent?"

Pursuit of an idiosyncratic policy goal contrary to the statutory structure, while not complying with the "particularity" requirement of Rule 23.1, is anarchic and conclusory to the point approaching "group libel". cf. *Beauharnais* v. *Illinois*, 343 U.S. 250 (1952).

ARGUMENT

Summary

We repeat the seventeen contentions in the pretrial order (pp. 33-36a) and add that plaintiffs have failed to comply with Rule 23.1, F.R. Civ. Pr., in that there are no allegations "with particularity" of any "efforts" or "reasons" for failing to make demand upon the unaffiliated majority of directors. We note that even had plaintiffs prevailed below, the point would be merged in the judgment and available here. *Papilsky* v. *Berndt,* 2 Cir. 1974, 503 F.2d 554, at 556.

The District Judge's reasoned decision is entirely adequate to dispose of this case on the merits. He analyzed ineligibility to NASD membership in precisely the terms used by Sabel (Ex. 23, discussed at pp. 22-23, *supra*).

Plaintiffs introduced as Ex. 38 Responses to Interrogatories 5, 6 and 7, a portion of which is stipulated (30a) in the Pretrial Order. The testimony of all of the outside directors fully supports that Ex. 38 and the reasonable basis of their decision not to enter a bona fide brokerage business (much less a shell or sham) for purposes of self-dealing on regional exchanges, funnelling brokerage business to thin markets which would have resulted in saving the *Adviser* money by absorbing its overhead, to contrive that some part of hypothetical profits might have been funnelled back for the theoretical benefit of the Fund.

A more fundamental issue is that this Court is being requested to go far beyond *Moses* v. *Burgin,* 445 F.2d 369 (1 Cir. 1971) to do what even that opinion expressly refused to do. That Court held "the directors had no duty" to create an affiliated broker and that plaintiff there "could have chosen a Fund that did have an affiliated broker", 445 F.2d at 375. No less than a dozen times that Court referred to "NASD" membership or "recapture" and always in the context of "dealer-distributed funds". Plaintiffs' sole claim

is that defendants should have created a brokerage firm—for either self-dealing or deceit.

While Congress could not have foreseen in December 1970, upon passage of the amendments to the statute, the June 1971 decision in *Moses,* it is submitted that new section 36(b), which became effective 18 months after enactment,* created an exclusive remedy, providing "the plaintiff shall have the burden of proving a breach of fiduciary duty" 36(b)(1). Further, Congress provided in 36(b)(3):

> "(3) No such action shall be brought or maintained against any person other than the recipient of such compensation or payments, and no damages or other relief shall be granted against any person other than the recipient of such compensation or payments. No award of damages shall be recoverable for any period prior to one year before the action was instituted. Any award of damages against such recipient shall be limited to the actual damages resulting from the breach of fiduciary duty and shall in no event exceed the amount of compensation or payments received from such investment company, or the security holders thereof, by such recipient."

Congress has been utterly done and quit of the sorry business. The 195-page report promulgating Rule 19b-2 (Ex. L, including no less than 552 footnotes to track the peregrinations of the SEC) permitting 20% self-dealing failed to meet the two Committees' demand of no conflicts (Exs. B and C), and now, Congress has enacted the "Securities Acts Amendments of 1975", flatly prohibiting by compulsory deadline any conniving "equity" to accomplish what plaintiffs claim defendants should always have done.

---

* Enactment was December 14, 1970. *Moses* decision was June 4, 1971. New §36(b)—exclusive remedy—was effective 18 months after enactment and a full year after *Moses* decision.

A. Failure To Comply With Rule 23.1, F.R.Civ.Pr., Compels Affirmance of Dismissal

The bald, conclusory allegations of paragraph 24 of the Complaint fail to "allege with particularity the efforts" to obtain action from the directors, including the separate and statutory majority of the disinterested directors, or the "reason for . . . failure to obtain the action or for not making the effort." This, of course, is the substantive law of New York, as well. § 626(c), Business Corporation Law.*

The statutory role of "unaffiliated" (later "disinterested") directors is both pivotal and decisive under § 15(c) of the Act. There is not one scintilla of evidence in the record which even hints at the possibility of domination of the independent, disinterested directors or of any self-interest or wrongdoing. Nothing in the record can supply the void of "particularity" required in the pleading.

In *Papilsky* v. *Berndt,* 503 F.2d 554 (2 Cir., 1974) this Circuit carefully reserved the right *after trial* to obtain judgment of dismissal for failure to comply with Rule 23.1. Moreover, this Circuit in *Brody* v. *Chemical Bank,* 482 F.2d 1111 (2d Cir., 1973) expressly approved pleading requirements mandated by *In re Kauffman Mutual Fund Litigation,* 479 F.2d 257 (1 Cir., 1973) under Rule 23.1 as relating to corporations of *any* state.

Now, any possible perplexity in harmonizing the circuits has been dissipated by Judge Wyatt's comprehensive decision published March 5, 1975 in *Jones* v. *Equitable Life Assurance Society of the United States* (73 Civ. 1701, February 14, 1975) CCH Fed. Sec. Law Rptr., ¶ 94,986. Judge Wyatt dismissed the federal claims for failure to satisfy the "particularity" requirements of Rule 23.1, and further

* The Fund's internal law. This Court could well affirm on the basis of *Greenspun* v. *Lindley, et al.,* —— N.Y. —— published N.Y.L.J., May 19, 1975, p. 1; decided May 5, 1975 by New York Court of Appeals. See *Hausman* v. *Buckley,* 299 F. 2d 696 (2 Cir., 1962), *cert. den.* 396 U.S. 885.

dismissed the purportedly "pendent" claims. The additional Massachusetts ground for dismissal in no way vitiates Rule 23.1 or § 626 (c) B.C.L.

We urge the Court to make threshold disposition under Rule 23.1, *after trial,* as contemplated in the *Papilsky* case, *supra,* as being the most wholesome corporate therapeutics, especially in the light of plaintiff's disgraceful depositions (Exs. R and R-1), which show not only failure and complete inability to meet the requirements of that Rule, but a flagrant disregard of the good grounds requirement of Rule 11, F.R.Civ.Pr.

Of particular importance is that in the *Kauffman* case, Note 1, 479 F.2d at 261, the Court after referring to its decision on the merits in *Moses* v. *Burgin, supra,* where no demand on directors had been made, stated ". . . we do not agree with plaintiff that our action was a sub silentio ruling on that issue." Since this Circuit in the *Brody* case, *supra,* in 1973 expressly approved the *Kauffman* standard of pleading, it cannot be contended that the passing reference to old Rule 23(b) in 1961 in *Brown* v. *Bullock,* 294 F.2d 415, 417 could in any way sustain the present complaint, sub silentio or otherwise.

The standing to bring an action in new Section 36(b) of the Act does not obviate a pleading, nor did it cure the pleading in the *Kauffman* case (1973). The conclusory words in Complaint ¶ 24 were expressly rejected as conclusory in *Kauffman* (479 F.2d at 263-264).

B. The District Courts Showing of Ineligibility To Join the NASD Was Entirely Correct

Eligibility to join the NASD, without fraud, was meticulously precluded by the Court below. It is sufficient here to note the 1967 correspondence with the NASD (Ex. A), the Sabel deposition in particular (Ex. 23), and the statement of facts, *supra* pp. 21-23, pp. 6-7.

C. Defendants Had No Obligation To Create a Brokerage Business, and *Moses* v. *Burgin* Is Authority for Affirmance

Plaintiffs' sole reliance is upon *Moses* v. *Burgin supra,* which is to try to present *Hamlet* without Hamlet. The case is authority to the contrary.

There, the "Hamlet" was Crosby Corporation, a functioning underwriter which for an underwriting fee had actively sold as a "dealer" to brokers and other dealers. There is no "Crosby"—no "Hamlet"—in this case. Shareholders subscribe by direct mail from the Fund itself, thereby saving more than 60 million dollars.

There, the Court first brushed aside plaintiffs' contention that the Adviser should have formed an affiliate for membership on regional exchanges, stating at 445 F.2d at 375:

> ". . . the directors had no duty to pursue plaintiff's suggested course of action, and without their doing so, *recapture was not freely available.* Plaintiff knew of Fund's practice when she bought her shares; *she could have chosen* a fund that did have an affiliated broker." (Emphasis added)

Then, on the same page 375 in the second column, the Court pointedly observed that the underwriter of the load fund was "already eligible" to receive give-ups. It stated "Crosby was a member of the NASD."

Under the caption "NASD Recapture" the Court said:

> "We turn, accordingly, to plaintiff's second major claim, that *without the necessity of a broker affiliate, or changing Crosby's methods of operations,* give-ups could have been channeled to Crosby—*already eligible* to receive them—to be applied against Management's advisory fee, a process that has been described as indirect recapture." (Emphasis added)

Chestnutt Corporation was under no duty to "[change] its methods of operations". As stipulated (Ex. 38, partially quoted 30a), all the directors knew of the methods of operations. Plaintiffs knew of the methods of operations when they became shareholders and "could have chosen a fund that did have an affiliated broker".

The Court left no doubt as to its intentions by quoting (p. 378, column 2) from PPI (Ex. 4, p. 173) what the SEC itself had said about "*dealer*-distributed funds", and their "adviser-*underwriters*, *all* of whom are NASD members". (Emphasis added)

No less than a dozen times the Court referred to "NASD" membership or "recapture", and always in the context of *dealer*-distributed funds.

Again, and to rivet attention on the existing nature of Crosby's business, inherent in the very nature of the distribution of a "load-fund", the Court (at p. 380, column 1) noted that the SEC itself had repeated the sentence from page 173 of PPI relating to "dealer-distributed" funds when promulgating a proposed (but withdrawn) Rule 10b-10.

Defendants here repeat and incorporate the contentions set forth in the pretrial order. Particular emphasis, especially in the light of the *Moses* case, *supra,* is placed upon contentions numbered "11" and "15". The Court may take particular notice that plaintiffs' claimed "equity" is now viewed with horror, not only by the SEC, Committees of both Houses of Congress (Tr. 102-106), but now by the Congress and President in the "Securities Acts Amendments of 1975."

D. Plaintiffs Have the Entire and Impossible Burden To Prove Both

(a) "Violation of Fiduciary Duty",

and

(b) "Receipt" of "Compensations or Payments".

When Congress in 1970 enacted new section 36(b) of the Act, after more than 5 years of most intensive study and exhaustive legislative history, it created an exclusive and preemptive new federal standard of fiduciary obligation, and to get rid of "strike suits" and "nuisance suits" added the revolutionary words, effective June 15, 1972:

> ". . . and the *plaintiff* shall have the burden of proving a breach of fiduciary duty". (Emphasis added.)

This legislation with respect to the unique structure of investment companies reversed and overturned the traditional burden of proof, as expressed in *Pepper* v. *Litton*, 308 U.S. 295, 306, that when a fiduciary is

> ". . . challenged the burden is on the director or stockholder not only to prove the good faith of the transaction but also to show its inherent fairness from the viewpoint of the corporation and those interested therein".

A court may not revert to general tradition where a specific legislative revolution has been commanded for a particular purpose. The Supreme Court in *Minnesota Mining etc.* v. *N. J. Wood Finishing Co.*, 381 U.S. 311 (1965), quoted the classic admonition of Holmes, sitting on circuit, in *Johnson* v. *United States*, 163 Fed. 30, 32:

> "A statute may indicate or require as its justification a change in the policy of the law, although it expresses that change only in the specific cases most likely to occur to the mind. The Legislature has the

power to decide what the policy of the law shall be, and if it has intimated its will, however indirectly, that will should be recognized and obeyed. The major premise of the conclusion expressed in a statute, the change of policy that induces the enactment, may not be set out in terms, but it is not an adequate discharge of duty for courts to say: We see what you are driving at, but you have not said it, and therefore we shall go on as before."

Accordingly plaintiffs must not merely "challenge", but must *prove* the "inherent" *un*fairness of defendants, despite full disclosure. The only analogy in our experience is congressional shifting of the burden of proof from the taxpayer to the Commissioner as to "unreasonable accumulations" under former §102 of the I.R.C. of 1939, now somewhat modified in §531, *et seq.* of the 1954 Code, especially §534.

Nothing was ever "received" by the defendants or ". . . paid by such registered investment company, or by the security holders thereof . . ." (§ 36(b) of the Act).

Since the hypothetical profits of a non-existent entity are zero (or a minus figure), there could not be the "actual damages resulting from the breach of fiduciary duty . . ." (§36(b)(3)).

Nor could any "trust" be imposed on a cipher, or the minus number of corporate disaster, which plaintiffs would treat as opportunity.

The circle is finally closed by realizing that plaintiffs' burden now is to prove that Congress is wrong in flatly prohibiting what defendants have never done, even though it granted a "grace period" to permit extrication from conflicts and folly. H.R. No. 94-229, 94th Congress, 1st Sess. Conference Report dated May 19, 1975 to accompany S.249, page 107.

CONCLUSION

The judgment of dismissal should be affirmed, with costs and disbursements.

Respectfully submitted,

Rogers Hoge & Hills
Attorneys for Defendants-Appellees (other than American Investors Fund, Inc., nominal defendant)
90 Park Avenue
New York, New York 10016
(212) 953-9200

Of Counsel:

Clendon H. Lee

2 copies received

COPY RECEIVED

'75 JUN 23 PM 1:59

POMERANTZ LEVY
HAUDEK & BLOCK

2 copies received

~~2~~ 1 COPY RECEIVED

6/23/75

ROGERS & WELLS
ATTORNEYS FOR